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Business and Economic Conditions

General Business Conditions

New York, June 1961

THE marked increase in industrial activity during April and May has erased any lingering doubts that the economy is in a very encouraging rebound from recession lows. Improvement in business sentiment—stimulated by better sales and by some improvement in earnings—has been most noticeable in the stepped-up tempo of ordering, particularly for durable goods, and in a moderate increase in plans for capital investment later this year. Inventory liquidation by manufacturers was largely completed by the end of April. However, some stock cutting continues where shipments of finished goods have picked up more rapidly than output, or where production is using up materials faster than they are being delivered. When rebuilding of stocks begins, a further stimulus will be given to recovery.

The most dramatic upswing in business activity during April was in the industrial sector. Not only did new orders, production, and shipments rise, but, on a seasonally adjusted basis, more workers were employed in manufacturing and the factory work week was lengthened. The rise in industrial production, as measured by the Federal Reserve index, amounted to 2.5 per cent in April with a further rise indicated for May. The recovery is on a broad base, encompassing all major industrial sectors. Rising output of steel and automobiles has attracted most widespread attention, but gains have extended into textiles, furniture, television, and industrial and farm equipment. It seems reasonable to figure that by now half the decline in industrial production has been made up.

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How Far and How Fast

With this auspicious start, the natural question is how far and how fast the recovery will go. The fact that the recession was mild does not necessarily point to either a mild or a strong recovery, since history affords examples of both.

A new study by the National Bureau of Economic Research, *Business Cycle Indicators,* edited by Geoffrey H. Moore, offers systematic examination of past experience. One finding, not unnaturally, is that "recovery to the previous peak was attained in a much shorter time after the moderate contractions than after the severe ones." Since the recent decline ranked among the mildest in the last forty years, business statistics may begin setting new records before many more months have passed. Historically, periods of business expansion have ranged from 10 to 80 months with an average of 30 months. The National Bureau studies fail to show any systematic relationship between duration of contractions and duration of ensuing expansions. The key to prolonging an expansion period rests in balanced growth and avoidance of speculative excesses.

As often happens in the initial stages of recovery, some types of activity which spurted upwards early this year have found it difficult to maintain the pace. Housing starts, which had

drifted lower throughout 1960 to an annual rate below one million units in December, rebounded to 1,317,000 in March but fell back 6 per cent in April to a rate of 1,233,000.

After a two-month rise, retail sales figures, seasonally adjusted, sagged in April, perhaps because the data do not make adequate allowance for the early Easter. However, new passenger car sales continued to improve in April and May, as they have done since mid-February. In the first 20 days of May, deliveries trailed 1960 by 13 per cent, compared with a year-to-year decline of 19 per cent in the first four months.

Total employment rose one million in May, about as much as usual at this time of year. The number of unemployed declined by 194,000 to 4,768,000, but the seasonally adjusted rate of unemployment, at 6.9 per cent of the civilian labor force, remained around the same level recorded in the preceding five months.

Further confirmation of the improvement in business sentiment already developing in March and early April was provided by a McGraw-Hill survey of 1961 plant and equipment expenditure plans. Such outlays are expected to total $35.4 billion; while this is 1 per cent below the 1960 level, it is a measurable improvement over earlier surveys which had indicated a 3 per cent decline. About 70 per cent of the expenditures —a larger share than usual—will be for modernization rather than expansion of capacity. Of course these plans are subject to change, depending on the strength of the business recovery and also on the outcome of the Administration's efforts to stimulate capital investment.

Tax Credits for Investment

The Administration's tax program, including a proposal to stimulate new investment through a complex system of credits against taxes, has been the subject of extensive hearings before the Ways and Means Committee of the House of Representatives. Although businessmen would receive an estimated $1.7 billion in tax credits under this proposal, nearly all the witnesses have testified against it, and the business community generally has viewed the program with reserve.

The Treasury's tax expert, Assistant Secretary Stanley S. Surrey, finds the reluctance to accept these incentive credits "genuinely puzzling." But the reasons are not hard to discern. Businessmen distrust the complexities and "gimmicky" characteristics of the plan, its manifest inequities, and the way the revenue loss would be recouped —out of the pockets of shareholders and firms with subsidiaries abroad. Businessmen already make too many decisions on the basis of taxes.

The tax credit device is pinpointed on the target of expanding and modernizing domestic industrial capacity. It would be available to most corporations, unincorporated businesses, and farmers—except for electric, gas, and telephone utilities and rental housing and hotels. A taxpayer could obtain credit against his taxes equal to 15 per cent of plant and equipment expenditures in excess of his depreciation allowances plus 6 per cent of investment between 50 and 100 per cent of depreciation. These credits are subject to an upper limit of 30 per cent of tax liability and many other accounting and legal limitations.

Secretary of the Treasury Douglas Dillon, in presenting the program to the Ways and Means Committee on May 3, emphasized that "the purpose of the investment credit is not to provide general tax reduction for recipients of profit income. Rather, it is to stimulate investment in the most efficient manner." The Treasury Department has estimated that application of this tax incentive should increase expenditures for plant and equipment by two to three billion dollars per year and create roughly half a million new jobs directly and indirectly.

Would The Plan Achieve Its Aims?

The aim of encouraging investment and thereby promoting economic growth is commendable, but whether this kind of stimulus would be "the most efficient" is a question. The plan is discriminatory—and deliberately so. The benefits would be greatest to new and rapidly expanding firms which regularly invest substantial amounts in excess of depreciation. Most such firms need no added incentive and would be investing in any event. On the other hand, the plan would do little for businesses which have just completed major investment programs, or for older industries which need to modernize but lack funds.

In a broader sense, the measure would give the most to industries employing large quantities of fixed capital. Manufacturers would benefit far more than merchants and service industries, where inventories and receivables are more important than bricks and mortar. A stimulus would be given to plant and equipment expenditures, but no new tax incentives would be provided for other outlays, such as those for research, design, or personnel training, which might contribute as much or more to progress.

The emphasis would be on spending, as opposed to the most economical application of resources, and on expansion of plant capacity as such, without regard to present abundance of productive facilities. As the Joint Economic

Committee has warned, the incentive to spend would be most powerful in times of rapid economic expansion, and thus might "tend to accentuate fluctuations in business activity."

There would be something offered to any businessman (outside the excluded industries) willing to go through the arithmetic and defend the results under the scrutiny of the Internal Revenue Service. To aid smaller businesses, a minimum credit of 10 per cent would be allowed on the first $5,000 of new investment. For example, a doctor who buys a new car this year for business purposes, or a farmer getting a new truck, could claim a windfall reduction of some hundreds of dollars on his 1961 income tax. The President, speaking of business expense deductions, urged that the slogan "it's deductible" should pass from our scene; but here would be a new deduction and one of the most glamorous type—right out of the tax rather than out of taxable income.

These are the features which have led to the labeling of tax credits as "gimmicks," "windfalls," and "subsidies" by representatives of business, government, and labor alike. Adding to business uneasiness over the new tax approach has been the Administration attitude that tax measures can be employed to manipulate the economy as well as raise revenue. Walter W. Heller, Chairman of the Council of Economic Advisers, stated on May 18: "The President's proposed incentive tax credit, now before the Congress, is frankly a device to swing the power of the Federal tax system behind the expansion and modernization of our industrial plant." Though tax powers may be used to benefit business today, their use in this fashion implies the ability to penalize tomorrow.

The deepest disappointment is that the investment credit plan may displace or postpone reforms in income tax rates and depreciation provisions that have had study and widespread support. These measures could give more lasting benefits to the economy and to the base of taxable income. If taxes are too severe, the fact should be recognized in rate reforms. Business needs better incentives, not discriminatory subsidies.

Withholding Dividends and Interest

President Kennedy's April 20 tax message proposed that about $1.1 billion of the $1.7 billion cost of the investment credit be recovered by adopting a withholding tax on interest and dividend income and by eliminating the tax provisions that permit taxpayers to exclude from taxable income the first $50 of dividends and to deduct a maximum of 4 per cent of dividends beyond $50 from their tax liability. The President gave an estimate that about $3 billion of taxable interest and dividends are unreported each year. Applying a 20 per cent withholding tax to this "escaping" taxable income, the President said, would increase Treasury revenues by $600 million a year.

In a May 3 supporting statement to the tax-writing Ways and Means Committee, Treasury Secretary Douglas Dillon asserted that efforts to reduce the gaps by educating taxpayers—a program in force since 1959—have not been effective. He contended that, while stringent enforcement measures might encourage more complete reporting of interest and dividend income, they would require inordinate amounts of time and money. On the other hand, he said, the system of tax withholding on wages and salaries in force since 1943 has worked very satisfactorily.

Proposals for a withholding tax on interest or dividends have been made repeatedly in the past, and, indeed, were passed by the House of Representatives in 1942, 1950, and 1951. Only last year a proposal nearly identical with President Kennedy's came up in the Senate but was defeated. Principles of both morality and equity obviously require that, as the President expressed it: "Recipients of dividends and interest should pay their tax no less than those who receive wage and salary income, and the tax should be paid just as promptly." Heretofore, however, no withholding proposals have been adopted, mainly because Congress has found on closer examination that such programs would create many troublesome problems for both payers and recipients of investment income.

"The 16-cent Proposal"?

The cost of dividend and interest withholding would be substantial because of the hundreds of millions of transactions of small average amounts. To be sure, some advocates have argued that withholding would be almost costless. Senator William Proxmire has said that banks and businesses which withhold dividends and interest would:

> simply send to the Treasury a check . . . at the cost of a 4-cent stamp. That is the entire cost. They would do this four times a year. Thus the proposal has been called by Mr. Pechman, who is principally responsible for this reform, the 16-cent proposal. It would cost a corporation, no matter how big it is or how small it is, only 16 cents a year.

This is a considerable oversimplification. True, under the proposal now being presented, the Treasury would not require businesses and banks to submit withholding statements to shareholders

or depositors. But even so, considerable expense would be involved. Senator John M. Butler of Maryland, in Senate debate, cited a study by the Mercantile Safe Deposit & Trust Company of Baltimore indicating that dividend and interest withholding would add more than $70,000 a year to its costs to cover the increased work involved for its dividend collection, bookkeeping, tabulating, income distribution, statement, investment, and tax divisions.

Moreover, the costs would be sharply increased if withholding statements were found to be necessary to back up people's claims for refunds at the Treasury. L. Chester May, treasurer of the American Telephone and Telegraph Company, pointed out recently that making refunds without demanding proof that taxes had been withheld would open the door to fraud:

> Anybody could do that—say he is a shareowner in this or that company, claim he doesn't have to pay taxes, and ask for a refund.

Any increases in business costs would reduce profits and accordingly Treasury revenues from the corporate income tax. At the same time, the necessity for refunds to people whose dividends and interest were withheld even though they owed no tax would load new work and expense onto the Internal Revenue Service which already has a problem of over 35 million claims for refunds a year.

Whatever may be said in favor of withholding, there is no merit in suggesting that it would be simple and "virtually costless."

The Problem of Overtaxation

A withholding tax on interest and dividends is intended to correct the problem of underreporting and undertaxation of such types of income. In doing so, however, it would create *overtaxation* for millions of people who otherwise would have little or no tax liability. Millions of senior citizens who by saving have created their own social security and who count on dividend and interest income to provide or supplement a modest retirement income would be injured. Even if school thrift accounts were exempted from withholding, there are still many children who would have 20 per cent withheld from "incomes" far below taxable levels.

To be sure, victims of overtaxation could apply for refunds of the money withheld, but many people understandably are concerned about how they would meet their bills in the months that go by until the first refund check arrives. Senator George Aiken of Vermont reported receiving a great many letters expressing concern from persons whose only income was from dividends or interest:

> One person in his letter said his income was $2,000 a year; that every dollar of it was from investments; and that that was all the income he had. He said he did not know what he would do if he had to wait to collect the $400 which would be withheld.

It would be a pity if the main source of added Treasury revenues proved to be the failure of many recipients of small amounts of dividends and interest to get refunds due them because they did not make the attempt—or did not understand how—to do so.

Advocates of the plan have argued that it would merely place dividend and interest recipients on the same basis as wage and salary earners. There is, however, a substantial difference. Withholding on wages is adjusted to the personal exemptions which the individual can claim. In contrast, withholding on dividends and interest would be a flat 20 per cent rate on *all* such income, regardless of how small a taxpayer's income might be or how large the number of dependents and exemptions. As a result, the withholding tax would be much heavier on income in the form of dividends or interest than it would be on wages or salaries. Dividend and interest recipients who owed no taxes, or were tax exempt, would have taxes unjustly withheld.

The following table shows the difference. The $2,600 annual income chosen to illustrate the relatively heavy burden on the dividend and interest recipients is by no means large. Indeed, it is no more than the Federal minimum wage of $1.25 an hour which the Administration recently worked so hard to secure. Yet, as the table shows, the President's proposal would reduce this modest income by 20 per cent, even when the taxpayer actually owed nothing to the Government.

Withholding Tax on $2,600 of Dividends and Interest Compared with Withholding on $2,600 of Wage and Salary Income

	Exemptions			
	1	2	3	4
Tax on $2,600 of income	$348.00	$228.00	$108.00	0
Withheld from wages and salaries ..	346.32	224.64	102.98	0
Withheld from interest and dividends	520.00	520.00	520.00	$520.00
Underwithholding on wages and salaries ..	1.68	3.36	5.02	—
Overwithholding on interest and dividends	172.00	292.00	412.00	520.00

Note: Tax computed for an individual who uses the 10 per cent standard deduction. Withholding amounts on wages computed on the basis of Treasury's "percentage method," which takes 18 per cent of the residual of weekly wages less $13 for each exemption.

As the table shows, for an individual who takes the standard deduction, withholding on $2,600 of wages would actually be less than the tax due. In contrast, for people whose income consisted of this amount of dividends or interest, overwithholding could run as much as $520 more than the tax due. Thus, the plan would

bear heavily on the tremendous body of little capitalists who make up the bulk of the 15 million shareholders and 40 million Savings bond owners, and who hold more than 100 million savings accounts of all kinds.

The suggestion has been heard that the plan would solve alleged evasion by rich people and thus end the need for business and banks to report larger interest and dividend payments to the Treasury on information returns. Handled in this way, the withholding scheme might seem to invite people in higher brackets to construe the 20 per cent as the final step of income taxation of dividends. To enforce collection at the higher rates on the tax progression, the information returns would still be required. The Treasury is already collecting taxes due on larger dividend payments; if not, the reason is failure to use available information for enforcement.

Uncertain Size of the "Gap"

The expense, inconvenience, and even hardship which dividend and interest withholding might involve would seem to call for considerable certainty that the revenue gains from it would be large enough to offset its disadvantages. The fact is, however, that no one can be sure about the amount of dividend and interest income that is improperly escaping tax.

A great part of the "gap" conceivably could represent nontaxable income going to children, retired people with double exemptions and tax-free pensions, foundations, pension funds, trade unions, and foreign official accounts. No one knows the aggregate of resources of tax-free organizations, though it is known that they are huge and growing. Hence, the possibility exists that the net yield of dividend and interest withholding, after refunds to nontaxable recipients, might be well below the $600 million hoped for by the Treasury.

No one can quarrel with the objective of minimizing the amount of dividend and interest income which is illegally escaping tax. The difficulty is to construct a mechanism for making refunds promptly to insure a minimum of hardship and inequity to dividend and interest recipients. This may not be possible without requiring business firms and banks to issue an endless stream of withholding statements which might raise costs to uneconomically high levels.

If it should prove impractical to develop a rapid refunding mechanism at reasonable cost, the best way out might be for the Treasury to give a further trial to its program of educating taxpayers to the necessity of reporting dividend and interest income on tax returns. The educational program has been in effect only since 1959, too short a period for a fair test in an environment in which dividend and interest income, once enjoyed only by the wealthy, has fanned out to segments of the population for whom keeping track of and reporting small interest and dividend payments is something new.

As Senator Butler put it, arguing for patience with the educational program: "I think we should wait until the results of that program have been determined before enacting drastic legislation of the type proposed. To do otherwise would be to change horses in midstream."

Moreover, Senator Butler emphasized that the Treasury could encourage greater reporting of dividend and interest income by making use of the information returns on dividend and interest payments already submitted to it by business and banks:

> The Treasury Department today has in its files information forms from corporations listing every dollar of dividend paid and to whom it was paid. This information can and should be utilized to discover who the evaders are. Until such time as it is utilized, I see no need to tax dividends at the source.

Repeal of Dividends Credit

While the proposal to withhold 20 per cent of dividends and interest would represent a change in the method of collecting taxes, repeal of the dividends received credit and $50 dividend exclusion would constitute an increase in taxes. As the law presently works, a person is permitted to subtract $50 from dividend income (the dividend exclusion) and is allowed a maximum of 4 per cent of the remaining dividend income as a deduction from the computed tax. The Treasury Department figures that repeal of these provisions would increase federal revenues by $450 million a year.

Over the 48-year history of federal income taxation in the United States, a number of methods have been applied to relieve double taxation of corporate profits distributed as dividends. During the first 23 years, 1913-35, dividends were exempt from the "normal" tax and subject only to "surtax." The dividends received credit in the Revenue Act of 1954 represented a new method, one paralleling the approach in Canada, where a 20 per cent credit is allowed the taxpayer.

President Kennedy said in his tax message:

> The dividend credit and exclusion are equally inadequate as a solution to the so-called problem of double taxation.
>
> Whatever may be the merits of the arguments respecting the existence of double taxation, the provisions of the 1954 act clearly do not offer an appropriate remedy.

They greatly overcompensate the dividend recipient in the high income bracket, while giving either insufficient or no relief to shareholders with smaller income.

To be sure, the dividends received credit and exclusion give no help to people who do not have enough taxable income to be taxpayers. This would be true for people whose gross incomes are small, for those whose incomes are largely tax exempt, or for those with numerous personal exemptions. But this could be said of any tax relief. By its very nature tax relief aids *taxpayers*.

For taxpayers, the benefit of the $50 dividend exclusion lies mainly in sparing shareholders the trouble of having to pay a tax on minor amounts of dividend income. The 4 per cent dividends received credit has the same value per dollar of dividend income for anyone, regardless of his personal income tax bracket. As the table below shows, it is worth $19.20 per thousand dollars of corporate profits before tax, an amount which is dwarfed by the compounded taxes levied on the corporation and again on the individual.

Federal Income Taxation on $1,000 of Corporate Profits* Paid Out in Dividends

Tax Computation	Personal Tax Bracket of Recipient $4,000	$10,000	$50,000	$200,000
Profits before tax	$1,000	$1,000	$1,000	$1,000
Corporate income tax	520	520	520	520
Profits after tax, paid out in dividends	480	480	480	480
Personal income tax†	124.80	182.40	360.00	436.80
Total tax, corporate plus personal	644.80	702.40	880.00	956.80
Div. rec'd credit (4%)‡	19.20	19.20	19.20	19.20
Total tax, corporate plus personal, after credit	625.60	683.20	860.80	937.60
Income after tax	374.40	316.80	139.20	62.40
Tax Rates (per cent)				
Corporate tax	52.0%	52.0%	52.0%	52.0%
Personal tax†	26.0	38.0	75.0	91.0
Total effective rate	64.5	70.2	88.0	95.7
Dividends rec'd credit	4.0	4.0	4.0	4.0
Total effective rate, after credit	62.6	68.3	86.1	93.8
Benefit of credit as per cent of:				
Total tax	—3.0%	—2.7%	— 2.2%	— 2.0%
Income after tax	+5.4	+6.5	+16.0	+44.4

* Corporate profits beyond $25,000, taxable at 52%.
† Added tax on additional income.
‡ Ignoring exclusion allowed on first $50 of dividend income.

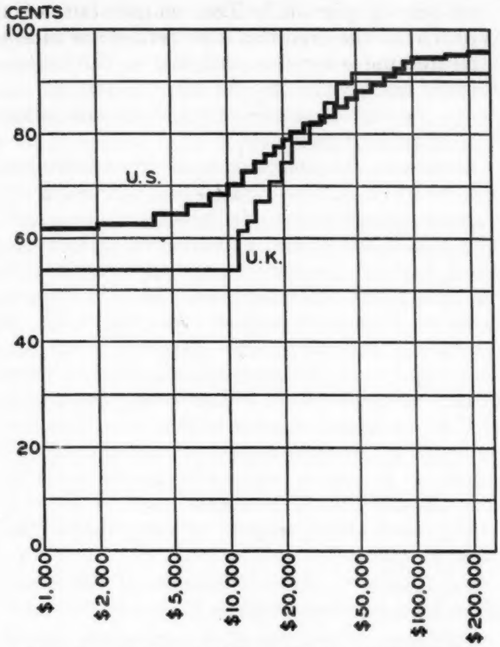
For a person in the $4,000 taxable income bracket, $1,000 of corporate profits paid out in dividends is taxed 52 per cent at the corporate level and 26 per cent at the personal level for a composite effective rate of 64.5 per cent. The dividends received credit cuts this back to 62.6 per cent, a tax reduction of 3 per cent. At the other extreme, for a person in the top income bracket, $1,000 of corporate profits paid out in dividends gets taxed at a composite rate of 95.7 per cent which the dividends received credit shaves to 93.8 per cent, a reduction in total tax of only 2 per cent. The computation of the benefit of the credit as a percentage of total tax refutes the allegation that the credit is biased in favor of rich people.

Anything, to be sure, can be proved with figures. Favoritism for the rich seems to be indicated in the fact that the dividends received credit permits an individual in the $200,000 personal tax bracket to retain 6.2 cents per dollar instead of 4.3 cents per dollar, or a betterment of 44 per cent. In contrast, the dividends received credit raises the amount that an individual in the $4,000 bracket can keep only from 35.5 cents to 37.4 cents, a rise in income after tax of no more than 5.4 per cent. In both cases, of course, the increase in retained income is 1.9 cents. This is bigger percentagewise for the wealthy taxpayer only because what he has left per dollar of income after taxes is so much smaller.

Befuddled thinking on tax policy overlooks the simple fact of confiscatory tax rate levels. Aimed at the rich, confiscatory rates strike at the opportunity to get rich—through savings out of taxable income—and at the incentive to develop taxable income. Moreover, to assert that the dividend credit is an imperfect solution to double taxation is surely no reason to abolish it entirely and leave both the small and the well-to-do shareholder with no relief at all from a widely recognized inequity and burden on savings. These are not tax policies well designed to encourage economic growth.

The two major nations where the most complaints are heard about the lack of vigor of economic growth are the United States and the United Kingdom. The new British budget is raising the corporate profits tax with the effect of putting the United Kingdom back ahead of the United States in maximum tax rates imposed by central governments on undistributed corporate profits. The new British rate will be 53.75 per cent against the U.S. rate of 52 per cent.

On the other hand, the British Government, acting to relieve taxation on "brains," is moderating the personal income tax progression by pushing out the point at which the surtax applies. This has the incidental effect of counteracting the impact of the increased corporate tax on profits paid out in dividends. If the Administration succeeds in gaining repeal of the dividends received credit, U.S. taxation of corporate profits distributed as dividends will be higher than the British scale except in the ranges of $28,000 (£10,000) to $32,000 (£11,429) and $33,600 (£12,000) up to $80,000 (£28,571). The comparison of effective U.S. tax rates with the United Kingdom is portrayed on the accompanying chart.



Taxation of One Additional Dollar of Distributed Corporate Profits as Related to Personal Income Tax Bracket of Recipient

(Logarithmic scale for personal tax brackets)

Note: Rates shown on the chart take into account the effect of tax changes proposed recently, such as: elimination of the 4 per cent dividends received credit in the United States; and in the United Kingdom the increase in profits tax from 12½ to 15 per cent and the increase from £2,000 to £4,000 in the amount of earned taxable income which is free of surtax.

It should give us pause that, with these limited exceptions, corporate profits paid out in dividends to American citizens are subject to the heaviest income taxation known in the world—with or without the modest dividends received credit. We have no excuse for not recognizing the danger of this course. Way back in 1942, the late Sumner H. Slichter wrote:

> The tax history of the United States in recent years has been fairly sensational. A visitor from Mars would suspect that a Communist fifth columnist was writing the laws for the purpose of making private enterprise unworkable.
>
> I am not complaining about the general level of taxes. Rather I am complaining of the extraordinary way in which taxes have been modified to bear heavily on any enterprise or individual who displays daring, backs an innovation or experiment, especially an experiment which is pretty certain to experience losses for a few years.

Taxing U.S. Investments Abroad

In his tax package President Kennedy recommended overhauling the tax treatment of income earned by Americans abroad. Secretary Dillon presented the proposals before the House Ways and Means Committee and pressed for prompt enactment.

The principal and most controversial proposals would make a far-reaching change in the long-established tax treatment of profits earned abroad by American firms operating through foreign subsidiaries. At present, such earnings are taxed in the country where the subsidiary operates and then again in the U.S. when they are distributed to the parent company in the form of dividends. Earnings retained abroad are not subject to U.S. tax. It is now proposed that the U.S. should tax earnings retained abroad by foreign subsidiaries in "economically advanced" countries. Profits earned and reinvested in "developing" countries would continue to be eligible for what the Administration proposals call the "privilege of tax deferral" (postponement). The tax burden on dividends from both areas would be increased by technical changes.

The idea is not only to enlarge U.S. tax revenues, but to make overseas investment in advanced countries less attractive to American industry. Thus it introduces a new concept of public policy. Ever since the United States, which was benefitted for many decades—and still is—by foreign investment in its own development, became in turn a capital generating and exporting country, it has been believed that U.S. investment abroad helped other countries by building up their production, stimulating their economic growth, and increasing their trade. Similarly, it helped the United States by expanding markets for U.S. products, building U.S. assets abroad, and providing a flow of income back to the U.S. investor. Economic history is filled with lessons of these mutual benefits. The history of Great Britain, whose investments helped build other countries and whose overseas assets in turn aided immeasurably in her fight for survival through two world wars, is a dramatic example.

The benefits of the flow of capital over international boundaries, which indeed is as natural as the flow of water from one level to another, have seldom been questioned in principle, though to be sure there has been much controversy on nationalistic or other narrower grounds. In these days of widespread government grants and aids, there seems special reason not to discourage the investment of private capital, which brings a return flow of income in support of the balance of payments and tax revenues, and which ought to be encouraged and expanded to lighten the burden the government programs lay on the taxpayer.

The new proposals therefore raise fundamental questions. One argument advanced for them is that they would reduce private capital out-

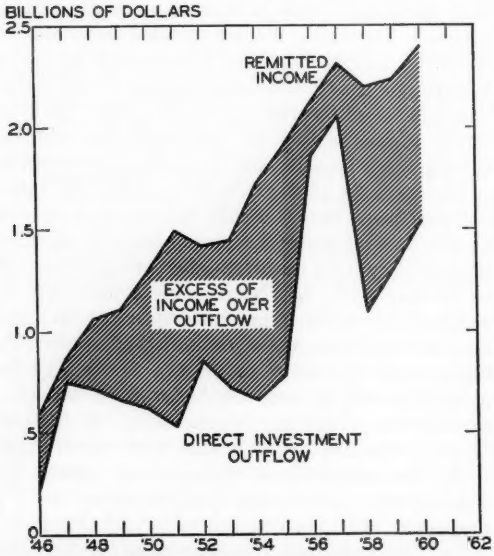
flows and bring about increased remittances to this country, thus helping to overcome the balance-of-payments deficit and win the "battle to safeguard the dollar." Another is that the change would make the tax system more equitable. The basic issues include not only these points, but how economic growth, production, trade, and capital formation everywhere would be affected.

"Battle to Safeguard the Dollar"

Implicit in the use of the balance-of-payments argument is an assumption that private capital investment is at least *a* bad boy, if not *the* bad boy, in the U.S. balance-of-payments problem. This, however, is contradicted by readily available figures.

Despite the implications that American corporations have been hiding income in "tax havens" abroad, the fact is that data of the U.S. Department of Commerce show that American corporations do bring home, for inclusion in U.S. income tax returns, large and growing amounts of earnings. Remittances of income, year after year, are larger than the outflow of new funds going into plants abroad—so-called direct investment.

As the chart shows, annual outflows of long-term capital for direct investment increased from \$0.5 billion in 1951 to a peak of \$2.1 billion in 1957, declined to \$1.1 billion in 1958 and rose to \$1.5 billion in 1960. Remitted income on private investment abroad runs to larger amounts, exceeding \$2 billion in each of the last five years.



U.S. Direct Investment Abroad and Return Flow of Income

Over the past decade, income on private foreign investment has exceeded the outflows of long-term capital for direct investment by \$7.8 billion. Income on foreign investments is—next to exports—the largest single source of income in the U.S. balance of payments.

Moreover, the comparison of capital outflow and remitted income understates the benefit of overseas investments to the balance of payments. The establishment and operation of an overseas plant typically means larger exports of U.S. machinery and other supplies. The U.S. Department of Commerce reports that the value of machinery and equipment exported from the U.S. for the use of American enterprises abroad in 1957 amounted to \$1 billion—about one fourth of U.S. machinery exports in that year. The Department is currently conducting another survey which, it is hoped, will be available early in June. In addition to machinery exports, there is a huge and steady export of components and other supplies.

Mr. Stanley C. Allyn, Chairman of the Board of the National Cash Register Company, has said:

> Following World War II, we strategically located overseas plants in highly developed countries which offered a broad home market and good prospects for exporting. By investing in such overseas plants, we were able to build up and support a marketing organization abroad which is also selling our newest and most complex Dayton-made products. As a result, our exports from Dayton have increased more than 10 times over the prewar years, and more than three times in the past 10 years. They are now at the highest level in our history.
>
> I think it is significant that these increased exports from our Dayton factory are not our low-price products, but rather our more sophisticated electronic and electro-mechanical machines. Without our plants abroad to meet overseas competition in simpler machines, we could not have maintained the marketing organization to sell our higher-price American-made products.

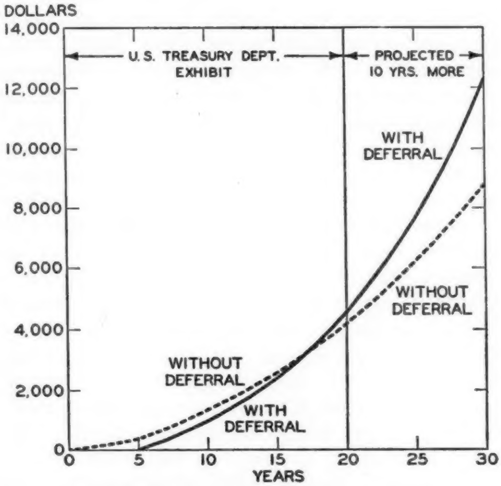
Investments and operations of U.S. corporations abroad constitute one of the strongest foundations to the U.S. balance of payments, both through remittances of profits and through sustenance of export volume.

Earnings Retained Abroad

The new proposals would penalize particularly foreign subsidiaries that customarily plow back earnings. Retained earnings are a common and necessary source of capital for expansion, abroad no less than at home. The growth and competitive potential of U.S. subsidiaries would be seriously impaired if they were to be required to pay both the foreign and the U.S. taxes on these earnings while their competitors paid only the foreign tax.

For the decade 1951-60, retained earnings are estimated by the Department of Commerce at some $9 billion. For the same period, new long-term funds supplied from the United States amounted to $11.4 billion. In the aggregate, therefore, U.S. direct investments climbed about $20 billion—to reach an estimated $32 billion at the end of 1960.

Earnings reinvested abroad generate profits the remittance of which bolsters the balance of payments. Secretary Dillon, in his testimony on May 3, presented a theoretical example showing that, under the assumptions stated, remittances will be larger for 17 years if income is fully taxed when earned, rather than if the U.S. tax is deferred.



Cumulative Remittances to U.S. From Net Earnings of a U.S. Foreign Subsidiary

Initial investment $1,000; annual rate of earnings before taxes 20%; foreign tax rate 20%; U.S. tax rate 50%. Reinvestment of all after-tax earnings for first 5 years, and reinvestment of half after-tax earnings for next 25 years.

It is interesting to see what happens in the theoretical example *after* 17 years. If the entire income is subject to U.S. tax when earned, there is obviously a smaller amount of after-tax profit available for reinvestment. If, on the other hand, U.S. tax is "deferred," more capital is reinvested, so that total investment—and, hence, remitted income—increases much more rapidly. While the Secretary recognized that remitted income would rise "over a long span of years," the fact is that at the end of only thirty years total remittances amount to 39.3 per cent more if there is "deferral" than without it.

The moral is crystal clear: Don't kill the goose that lays the golden eggs. Or, to use another analogy, a farmer can build up his bank account by refusing to purchase seed. His saving is only a temporary one, however, and disappears when there is no crop to harvest.

Tax Equity

The Administration further takes the position that, by failing to subject currently to U.S. tax the entire earnings of foreign subsidiaries, our legislation favors foreign earnings in preference to domestic earnings. The Administration calls this "tax deferral" and has said such deferral is a "privilege." Others have called it a "subsidy."

Such words overlook the fact that the subsidiaries compete, not in the United States, but in other tax jurisdictions. Equal treatment of taxpayers is, of course, an eminently desirable principle. The question, as put by Representative Hale Boggs, is: "Equal to what?" Surely, the proper comparison must be with the corporations abroad with which foreign subsidiaries compete. American income taxes are more severe than those of most foreign countries; thus, the effect of increasing the severity of U.S. taxation applicable to income earned abroad is to put American business under additional handicaps in the world markets.

The intent of the proposals is to achieve "tax neutrality" as between American enterprise operating at home and in "economically advanced" countries abroad. But foreign operations are conducted in an entirely different tax climate. Foreign countries typically collect far greater proportions of their revenues by turnover, excise, stamp, and capital taxes for which no credit is allowed against the U.S. tax. Accordingly, attaining mathematical equivalency of income tax rates between a foreign subsidiary and a U.S. corporation does not assure equality of tax burden. On the contrary, the new tax proposals would frequently impose a heavier tax on U.S. business abroad than upon domestic corporations.

Finally, the new proposals disregard the fact that business abroad operates outside the full protection of U.S. laws and is exposed to greater risks and losses as from confiscations, nationalizations, devaluations, and barriers to remittances of profits home. There are countries, even in Europe, where earnings continue to be blocked by exchange controls; it would be inequitable to tax book profits which are not, in fact, available in dollars for satisfying U.S. income tax liabilities.

"Tax deferral" is not a privilege; still less is it a subsidy. The present law simply recognizes the fundamental principle that income is not taxable until received.

Distinction Between "Advanced" and "Developing" Countries

The purpose of the proposals is to make investment in "economically advanced" countries less attractive to U.S. business. On the other hand, the tax "deferral" for income from U.S. investment in the "developing" countries is presented as "helpful" in fulfilling the Free World's "strong obligation" to assist in the development of these economies.

In the Western Hemisphere Trade Corporation Act, under which corporations operating predominantly in the Western Hemisphere are entitled to a 14-point reduction in the corporate tax rate, we already have a distinction in tax laws applicable to overseas income. This is something geographically precise, whereas the proposed distinction between "advanced" and "developing" countries would be based on changing judgments and perhaps political attitudes toward particular countries. The criteria for distinguishing between these two types of countries have not been officially stated; the Treasury has merely published a list of 29 countries considered "ineligible for deferral," including not only areas like Europe, Canada, and Japan, but also a miscellany of territories like the Bahamas, Bermuda, and Hong Kong.

In fact, all countries, whether "advanced" or not, are "developing." A country like Italy is "economically advanced" in the north and "developing" in the south. All countries can mutually profit from competition of business enterprise operating internationally, regardless of which nation issues the charter of incorporation. A given foreign subsidiary may be designed to carry on business in several countries in varying stages of economic development. A subsidiary based in Europe may do most of its business in Africa.

Generally, an American company venturing abroad for the first time will choose a fairly well-developed country where business practices are somewhat similar to those at home. Success there leads to a willingness to consider greater risks in other overseas areas, with earnings generated by foreign subsidiaries in "advanced" countries turned over for investment in younger nations.

The global operations of U.S. business are so interrelated and interwoven that any attempt to discourage expansion in the "advanced" economies cannot help but retard expansion in the "developing" areas, thus defeating the very purpose the Administration is attempting to achieve.

Tax Incentives Abroad

Other countries have long recognized the special risks, as well as national advantages, in overseas investment. France, Italy, the Netherlands, and Switzerland impose virtually no tax on profits derived from foreign branches and have easier rates on dividends from qualified foreign subsidiaries. Belgium reduces the proportional tax on foreign profits to a fraction of the regular rate. In Germany, the tax authorities can extend special treatment (up to complete exemption) to income generated by business activities abroad that are of interest to the German economy. France, Germany, and Sweden have negotiated tax treaties with other countries which provide that their citizens will be totally or partially exempt from taxation on income realized from investments in treaty countries.

In the United Kingdom—known for its stiff taxation—tax deferral was extended in 1957 to so-called Overseas Trading Corporations on profits derived from foreign branches. A similar plan for U.S. corporations (the Boggs bill), supported by all branches of the Eisenhower Administration, passed the House by a narrow margin a year ago, but failed to be approved by the Senate Finance Committee. Another noteworthy feature of British taxation is the generosity of tax credits on dividends received from overseas. Under the new British budget the government would be authorized to include in tax treaties with other nations a clause giving a United Kingdom resident credit for a tax waived by the country where an investment is made—so-called "tax sparing." In other words, credit is given for taxes even though they are not required to be paid. The purpose is to avoid nullification, by the British tax system, of incentives given by another country. In the United States, "tax sparing" clauses have been inserted into tax treaties negotiated in the past two or three years with certain less-developed countries, but none of these treaties has been ratified.

"Tax Havens"

The Administration also aims at ending the use of "the tax haven device" by American companies. There are practical difficulties in the way of enforcement of U.S. tax laws beyond the national boundaries though the improved reporting techniques authorized by Congress last year should help.

But to condemn the use of holding companies chartered under the laws of such countries as Switzerland and Panama is to overlook the useful and important economic functions which they serve. These countries do not tax foreign income realized by their citizens, including corporations chartered under their laws. Like Delaware charters for domestic holding companies, Swiss charters offer convenience for international holding companies which, to carry

on business, must have subsidiaries chartered and taxed under laws of different countries. A Swiss holding company makes it possible to channel earnings from an established subsidiary in one foreign country into new investments in another foreign country without the imposition of U.S. tax. It is a pity that U.S. laws do not permit a U.S. holding company to do the same—in other words, operate as a tax entity without taxation on sheer transfers of capital within the enterprise as a whole.

As the President of Pfizer International, Mr. John J. Powers, Jr., so pertinently remarked, "to the extent that headquartering in a 'tax haven' country may have saved the payment abroad of foreign income taxes, it has automatically increased the U.S. income tax payable when dividends are brought home. 'Tax havens,'" he added, "are looked upon by many foreign governments with appreciation rather than suspicion, as evidenced by the fairly widespread practice of foreign exchange conscious governments of approving transfers of foreign industrial holdings to Swiss-based companies."

The idea that American corporations accumulate hoards of cash in foreign subsidiaries to avoid U.S. income tax is a delusion. The dominant practice is to remit the maximum of profits consistent with the capital needs of the foreign subsidiary. In fact, as overseas banks and branches of American banks can attest, foreign subsidiaries are heavy borrowers of local currencies to support their working capital positions and reduce exchange risks.

What Needs to be Done

Certainly our tax laws are in need of repair, specifically including taxation of income from overseas investments. But the point of view should be one of encouragement which recognizes that private investment abroad strengthens America's place in the world.

Over the past several years, the Congress has devoted much careful study, in the hearings on the Boggs bill, to the tax treatment of income from investment abroad. In particular, it has sought to devise a method of taxation applicable to U.S. corporations almost wholly engaged in foreign operations that would enable U.S. business to go abroad under the American flag and compete with business abroad on something approaching tax equality.

American business wants neither subsidies nor penalties but only equitable tax treatment that gives fair opportunity to go abroad and market American ingenuity and know-how. The U.S. balance of payments and tax revenues will benefit; but the greatest gain will be in the political and economic strength and cohesion of the Free World.

Getting Taxes in Focus

It would be a pity if the widespread opposition to many of the specific proposals included in the Administration's tax program were to be regarded as blind resistance by the public and the business community to any and all changes in the tax structure. This is by no means the case. Indeed, many businessmen who oppose some or all of the specific proposals applaud the Administration for recognizing the importance of reconstructing the tax system. As Howard C. Petersen, speaking for the CED, told the Ways and Means Committee:

> The Administration is to be commended for its initiative in offering proposals for the reform of the Federal tax system, even though these proposals are limited. Although we disagree with many of the Administration's suggestions, we believe that by making proposals which can be debated and amended the Administration greatly increases the likelihood that something constructive will happen.

The 250 witnesses who have asked to be heard by the Ways and Means Committee are not trying to be obstructive. They know from actual experience that tax laws can have powerful, unintended effects and that the people and businesses subject to them may be in a better position to evaluate the drawbacks than Treasury experts.

The critics of the tax program fear that tax "gimmicks" will simply thicken the jungle of tax considerations which already are choking off productive business efforts and diverting energies into schemes for reducing tax liability. The need now is to slash away overcomplicated and outmoded tax provisions, not to add new complications. As *Business Week* said last month:

> This is no time to add further complexities to our already labyrinthine tax system. The reform of that system—which Kennedy himself says is a must for the next session of Congress—should aim at simplicity and equity—with tax considerations playing a minimum role in the process of making business decisions.

This is not easy, as the controversy about the President's tax program indicates. But the merit of full and free discussion before the Ways and Means Committee is that it focuses attention on the real contours of the tax problem as experienced by American business and individuals. They know where the shoe pinches. What is needed is a fairer tax system more hospitable to enterprise and growth. The heart of the tax problem is excessive rates. A real effort to bring these down could not only relieve pressures for evasion, avoidance, and tax havens, but also bolster incentives and opportunities for productive accomplishment.

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